

MARKET UPDATE

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UNFOLDING OF THE CREDIT CONTAGION

The credit crunch of late 2007 became a full blown liquidity crisis in early 2008, leading many economists to suggest that the rapidly slowing U.S. economy entered a recession during Q1. The housing market continues to be key and until it offers signs of improvement we are unlikely to be near an end of the current problems. The accelerated decline of U.S. home prices offers little near-term encouragement. Year-over-year sales prices in the ten largest U.S. cities declined 11.4% in January, signaling the largest drop in the 20 year history of the S&P/Case-Shiller Home Price Index. Housing declines brought home owner equity to a record low of only 48% and helped contribute to rising delinquencies and surging foreclosures.

As the housing market deteriorated further, prices of subprime and other mortgage securities continued to plummet, causing many large banks and investment banks to announce huge write-offs and attempt to protect their balance sheets by selling "risky" assets in favor of Treasury bonds. The increasing concerns surrounding many financial institutions, including the monoline bond insurers, created even greater turmoil in the complex debt structures that fueled liquidity. Some markets, such as that for municipal auction rate securities, seized up and ceased to function smoothly and many of the structures that supported pooled corporate and consumer debt (i.e. CDOs, SIVs, CLOs) simply disappeared. This resulted in severe concerns over liquidity and sys-

temic risk that reached its crescendo with the NY Fed engineered "rescue" of Bear Stearns by J.P. Morgan.

Most investors are pleased to see the first quarter becoming just a memory. Stock markets around the world were volatile as they struggled to digest the worsening credit crisis, weak economic statistics and the large bank write offs. During the quarter the S&P 500 was down 9.5%, the DJIA fell 7.6% and the tech-heavy NASDAQ declined over 14%. Led by sharp declines in Asian stock markets, international stocks fared poorly as well with EAFE down 9% and emerging markets down over 11%.

What's Going On?

The U.S. economy continues to

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OPPORTUNITIES IN CRISIS: BANK LOANS & TIMBER

With the slowing world economy and recent global stock market weakness, it may feel tempting to rush to the sidelines and wait for the "all clear" bell to ring before getting invested again. Unfortunately, the "bottom" is only visible in hindsight and, as the strong returns so far in April highlight, investors in cash run the risk of missing the opportunity for returns. For long term investors, volatility creates opportunities to consider, and the ongoing credit carnage has created at least two opportunities that we have added to client portfolios.

Leveraged Bank Loans

The market for "bank loans", (aka "leveraged loans"), has been punished by technical pressures that are in contrast to strong fundamentals. Bank loans are short-term loans that pay a floating interest rate based on LIBOR. While generally made to restructuring corporations, in recent years bank loans have predominantly been issued to fund leveraged buyouts.

While these loans are below investment grade and are a "cousin" of high-yield bonds, we are most interested in "senior secured" loans.

These loans rank higher to a company's other debt (as well as equity stakes) and stand first in line in case of default; therefore representing less risk than high yield bonds.

In recent years, bank loans enjoyed relatively strong and stable performance. However, in the summer of

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Crestwood Advisors LLC
50 Federal Street, Suite 810
Boston, MA 02110

Voice 617.523.8880
Fax 617.523.8118
www.crestwoodadvisors.com

Michael A. Eckton, CFA
Principal

Robert G. Ix, CFA, CIC
Principal

John W. Morris
Principal

Daniella M. Boni
Investment Services Assistant

Leah R. Cadillac, CFP®
Associate

Jonathan D. Callahan, CFA
Equity Analyst

Margaret L. Sweet
Investment Services Coordinator

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slow and the over-leveraged U.S. consumer seems to have hit a wall while caught in a "perfect storm" of falling home values, tightening credit conditions, a stalling job market with weak wage gains, and accelerating inflation. A quick glance at the chart below shows just how much rising home prices and mortgage equity withdrawals (MEWs) influenced GDP growth this decade and hints at just how much consumers depended on MEWs for spending.

Inflation trends in basic consumer goods are disturbing. Rice is up 75% in the past two months while corn is up 30%

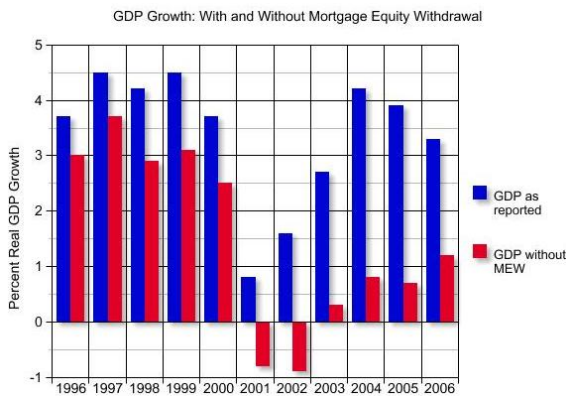
so far this year. Wheat prices have risen 120% or so over the past year. Crude oil prices seemingly hit record highs daily and the nationwide average price for gasoline is around \$3.50 per gallon.

The weak dollar is further pressuring consumer inflation by contributing to the rise in import prices. With the rising costs of food and energy becoming a

larger share of most budgets, we suspect that consumers will be under increasing pressure and curbed spending will continue to slow GDP growth.

The Era of De-Leveraging

De-leveraging and credit contraction will also curb domestic GDP growth in the months and perhaps years ahead. While current inflation trends are troublesome, the risk that the ongoing global debt liquidation will spin out of control and result in the collapse of the financial system is even more frightening. It is estimated that every \$1 of bank capital equates to \$10 in available credit. Given the significant losses and impairment of bank capital since mid-2007, as well as the collapse of much of the



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OPPORTUNITIES IN CRISIS...

2007, turmoil overtook the credit markets and an enormous overhang from private equity deals in 2005 and 2006 further compounded the problem. As credit problems worsened, major bank loan buyers such as CLOs and hedge funds disappeared, making it nearly impossible for underwriters to sell an estimated \$300 billion of LBO debt they committed to financing during better days. Low default and loss experience has led support for bank loans to generally trade close to par; however, the second half of 2007

showed deterioration in pricing which fell even further in early 2008.

Fundamentally Sound

Defaults over the last 15 years have averaged about 2.3% and actual losses have run much lower given the security of loans and high average recovery rates.

Currently, defaults are under 1%, indicating that credit deterioration has not been the reason for the recent price decline, but rather a technical supply/

demand imbalance. Given that there remains simply no market for many mortgage related assets, many banks, hedge funds and other investors were forced to aggressively sell what they

could (including bank loans) to raise cash and meet margin calls. By early March, many of these leveraged loans were trading in the mid-\$80s, reflecting the unlikely conditions of 15% annual default rates, losses well above historical precedent and a severe recession.

During the telecom bust earlier this decade, defaults peaked around 7.5%, and even with recovery rates dropping to around 60%, actual losses peaked at only 3.5% in 2001. The "implied" 15% default rate is 2x higher than the experience of the telecom bust and 3x higher than the S&L crises of the early 1990s – widely considered to be the worst credit crisis of the past 30 years. With the average bank loan maturity of 4-5

years, this suggests that investors are expecting more than 50% of these outstanding bank loans to default, which our research indicates is not probable. With strong fundamentals and pricing on bank loans backing up to +600 bps to LIBOR, we are happy to collect meaningful 6%-7% income distributions as we wait for the dust to settle on a technically shaken market.

Timber-rrrrrrrr!

The weakness in the U.S. housing market since 2005 has caused prices of raw lumber to fall by about 50%, pressuring the stocks of publically traded timber REITs and creating an opportunity for long-term investors. Presently,

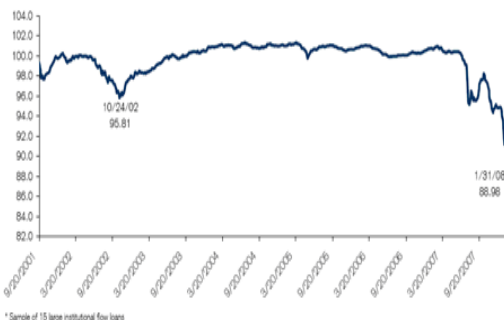
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Crestwood Advisors' Philanthropic Commitment

The CRUDEM FOUNDATION

The mission of The CRUDEM Foundation is to support and operate the Hôpital Sacré Coeur in Haiti. This hospital is located in the village of Milot and is the only hospital in northern Haiti to provide quality healthcare to the sick and the poor regardless of their religion, economic status or affliction. Though the hospital has only 64 beds, it provides care for 3,000 in-patient admissions annually and serves more than 60,000 outpatients a year.

For further information, we encourage you to visit www.crudem.org.



* Sample of 15 large institutional flow loans

CURRENT MARKET . . . (CONTINUED)

non-bank financial system, the amount of credit available has already declined meaningfully.

With losses likely to grow further in the months ahead, it is clear that capital availability will continue to shrink significantly.

These losses have lessened the willingness of bankers and others to lend. Though monetary policies have eased and interest rates have come down, credit availability remains tight and borrowing rates for both consumers and businesses remain stubbornly high as banks are seemingly unwilling to take on any additional credit risk. Declines in residential mortgage rates have not kept pace with the fall in treasury yields and refinancing is not available for many struggling homeowners.

“The Fed has responded to the worsening credit crunch aggressively, sharply lowering interest rates by two full percentage points in Q1....”

Credit is shrinking both in the U.S. and worldwide and is not available for many sectors of the economy. Asset values have deteriorated and illiquidity has prevented transactions from finding a true market value. By most definitions, this credit shrinkage is deflationary and global central banks are acutely sensitive to avoiding a credit induced deflation that could destabilize the global financial system. Certainly, this thinking contributed to the weekend “rescue” of Bear Stearns.

Encouraging Fed Response

While each financial crisis is different, the massive scale of the

expected losses and the interrelationship of global finance certainly makes this situation unique.

The Fed has responded to the worsening credit crunch aggressively, lowering interest rates by two full percentage points in Q1, including two 0.75% cuts that were the largest single cuts in over 20 years. The Fed also created new lending facilities to inject liquidity into the financial system to ease stress in both the capital markets and at individual banks. Both the Term Auction Facility and the even more expansive Term Securities Lending Facility provided broader access to potential borrowers, extended loan maturities and expanded the type of asset collateral that could be used for loans. These actions al-

lowed banks and non-banks to access fresh capital and allowed struggling firms to temporarily swap illiquid, impaired mortgage collateral for cash and treasury securities.

The federal government also stepped in with \$100 billion of tax rebates as part of a broader stimulus plan and provided new legislation for **Fannie Mae** and **Freddie Mac** to guarantee larger loans and expand their portfolios.

While not exactly the same, the handling of the Latin American loan crisis during the 1980s offers reassuring parallels. Back then the U.S. banking system was technically bankrupt and overextended with “AAA rated” but defaulting sovereign loans. The Fed effectively allowed these assets to

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OPPORTUNITIES IN CRISIS . . . (CONTINUED)

private timber transactions are trading at 2x the value implied by the current share prices of timber REITs. Our analysis of the three largest timber REITs (**Plum Creek**, **Rayonier**, and particularly **Potlatch**) suggests an opportunity to indirectly own timberlands at a significant discount to net asset value, while earning healthy and growing levels of cash flow and dividend income.

Diversification benefits

Historical analysis of asset class correlation demonstrates that timber exhibits remarkably low correlation with other asset classes and offers significant diversification benefits. In the last 45 years, timber has had only 3 years of negative returns versus 14 years in the equity markets. Surprisingly, these diversification benefits were achieved with returns that averaged about 14%, or what might be

expected from more volatile asset classes.

Attractive Business Model

Most timber REITs operate vertically integrated business models. Timber harvesting offers the highest margins, but these REITs have the ability to supplant cash flow with “better use” land sales, as well as pulp/paperboard manufacturing & consumer paper products, providing flexible revenue sources.

The current weakness in timber pricing from the housing crisis has led many companies to delay 2008 harvests, and instead focus on pulp, paper, and consumer sales, where the pricing environment is much more healthy. Importantly, there is minimal opportunity cost when the company delays timber harvests because trees grow 3%-6%

per year and become more valuable as they age.

Why Potlatch?

One of the more attractive timber REITs is **Potlatch (PCH)**, which owns about 1.8 million acres of timberland in Arkansas, Minnesota, and Idaho. As a REIT, the company is required to pay out most of its earnings in the form of dividends, resulting in an attractive 5% dividend yield.

Potlatch’s quality management has demonstrated a willingness to create value, increasing our confidence in near term catalysts for the stock price. PCH recently announced plans to evaluate options for the lower-margin paper businesses and has been mulling the sale of several less attractive manufacturing mills.

At the peak of the housing market in 2005, PCH traded as high as \$60 per share, falling below \$40 in late 2007. Our analysis suggests that this sell-off is overdone and that there remains plenty of value at PCH. Using conservative estimates of historical timber transactions for both timber harvesting and “better use” land parcels (ie: vacation development), we estimate that PCH’s land assets are worth about \$60 per share and the market is mispricing PCH due to the mass-exodus of anything remotely tied to housing. While there is always the risk of volatility, with the stock price now in the mid-\$40s, the risk/reward is favorable and we are willing to be patient with the 5% tax-advantaged dividend until cyclical timber prices improve and investors again begin to see the forest through the trees.

CURRENT MARKET . . . (CONTINUED)

remain “AAA” by letting banks avoid the losses associated with “marking them to market” until they had sufficient profits to absorb the losses. Clearly the Fed moves so far this cycle are also aimed at buying time to allow the currently impaired banking system to stabilize to the point where it can better absorb future losses.

Our View

Such a scenario leaves much room for pessimism but we find reasons for optimism as well. The Federal Reserve seems to grasp that the current situation extends beyond sub-prime mortgages and we are encouraged by

their aggressive easing and willingness to create new rules. At the same time, away from the broad financial sector, corporate balance sheets remain in very good shape. Stock markets have reacted sharply and reflect much of the fear of the current problems. Valuations are reasonable and while earnings estimates may be reduced, the U.S. stock market trades at 14x earnings, roughly in line with its historical average. As U.S. banks and consumers de-lever, there will certainly be bumps along the way. Our long held concerns of a consumer-led slowdown have kept us away

from investments most dependent on consumer spending. We also have little direct exposure to the most at risk sectors; housing, auto and banking. Accordingly, we are focusing on the opportunities being created by the current credit problems. We describe two such opportunities in the article beginning at the bottom of page one and continue to evaluate others as events unfold. In short, we do not believe that now is the time to make dramatic portfolio changes as the strategies we implemented some time ago are now bearing fruit. Our significant, non-dollar

exposure through both direct investments in international bonds and stocks, as well as a focus on non-U.S. revenue sources for our stock portfolios has been beneficial given the slowing U.S. economy and weakening dollar. At the same time, we have captured much of the gains from surging commodity and energy prices. The U.S. and world economies will withstand the current credit crunch and the opportunistic adjustments that we are making now to our strategies will enable us to take full advantage of the eventual recovery.

TAXES: ON THE RISE?

In the middle of a fervent campaign season, the issues surrounding tax rates are newsworthy once again. Contributing to policy discussions among candidates are fiscal issues ranging from the rising price tag of changes to government programs like Medicare and other entitlement programs, to the increasing national debt, currently nearing \$9.5 trillion. While it is unlikely that any tax changes will be enacted before the next President and Congress have a chance to settle in, many agree that the tax code is likely to be adjusted, perhaps considerably, in 2009.

An election year makes it especially difficult to separate political posturing from the facts about the current state of our taxes and indeed the overall health of our

unbalanced budget. Government spending continues to rise and mandatory spending on recurring programs like Social Security has been gaining ground on discretionary spending; demanding increased funding due to inflation and other causes. Given the current economic environment, these mandatory commitments appear to indicate that higher spending is predestined. Today, certain taxes remain very low relative to recent history and regardless of who next resides in the White House it is likely that taxes will rise in the future.

Who Pays?

Individuals represent the largest contributors to our overall tax revenue at nearly half the total. This is followed by social insur-

ance taxes (including Social Security & Medicare), which have been on the rise as a share of total revenue and represent roughly 1/3 of overall tax revenue. Meanwhile, corporate taxes have fallen to just less than 15%.

Capital Gains: A Likely Target

One of the most highly debated and publicized issues is tax rates on capital gains for individuals, which are at their lowest since 1941 and are a likely target for increased tax revenue. This is one area where individuals can take preventative action to shield current imbedded unrealized gains against future tax rates. While paying taxes on capital gains is generally a welcome by-product of a successful investment strategy, we are encouraging clients to consider setting a higher than usual capital gains “budget” for 2008 given that it is the last year in which we know Federal capital gains rates will

remain limited to 15%. (While unlikely, once a new President is elected, any newly passed tax legislation may be eligible to be rolled back to January 2009.) As long as consistency is maintained within the overall investment strategy, actively harvesting unrealized gains this year will likely prove prudent in the years ahead. A runaway deficit and current budget spending that requires an increase in tax revenues, combined with the politics of an election year, seem to promise that we will see changes in the tax code and quite likely higher tax rates. While it is impossible to protect potential capital gains from unknown future taxes, accelerating the sale of low-basis holdings will shield currently imbedded gains from paying what is likely to be a higher rate in the future.

Providing comprehensive investment solutions to high net worth individuals, foundations and endowments